The Great Recession

Lawrence J. Christiano
Transportation Center, Business Advisory Council, May 3-4, 2017
Objective

• Discuss the Great Recession, 2007-?

• What caused it, what made it last so long?
  • Why did so few people see it coming?

• Implications for World Trade and Policy.
Great Recession

- Big, by post World War II standards.

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<td>US Great Depression (1929 to 1933)</td>
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Smaller than Great Depression.

Total Production Over Population

Source: U.S. Bureau of Economic Analysis
fred.stlouisfed.org
Great Recession: Why did it Happen?

• Initially, very puzzling....scary even.

• Overbuilding in real estate led to imbalances:
  
  • Unemployed construction workers looking for jobs.
  
  • ‘plenty of jobs (e.g., nursing), but unemployed (e.g., construction workers) didn’t have the right skills’
  
  • Problem: unemployment was high across all sectors.

• Obamacare:
  
  • Fear that ACA would raise costs of business led ‘wait and see’ attitude about firm investment and new hires.
  
  • Problem: Surveys of firms suggested that their main problems were ‘lack of sales’.
So, What Caused it...what was the trigger?

• Correction in Housing Prices in Mid-2006.

  • But, like Mrs. O’Leary’s cow and Chicago fire, did not *have* to bring down the housing market and whole economy.
Trigger: house prices stopped rising in May 2006.

Housing Price Correction Need Not Have Led to House Price Collapse and Collapse in Economy.
What turned the housing price correction into a disaster?

• Housing price correction led to bank run.
This is what a bank run looked like historically.

This time, bank runs were invisible to most people (Gorton).

Run was on *Shadow Banking System* not commercial banking system.

It was not generally known how huge the Shadow Banking system was and how Vulnerable the Shadow Banks were.
The Drama of the Bank Runs Brought to Life in Some Great Movies!
Why did it last so long?

• As credit to housing sector dried up, housing prices fell sharply.
  • Fall in housing prices made homeowners feel poor, and cut back spending.
  • Firms seeing fewer sales, cut back investment.
  • Economy in a tailspin.

• Perfect storm: standard solution to recession could not be implemented when interest rates hit zero.
  • A big infrastructure program might have helped.
What about trade?
Economic activity in US and other countries remains weak.

Investment especially weak, reducing Trade.
Trade has slowed down with relative weakness in US, Chinese and other Economies. Also, World Trade Organization Reports that trade restrictions are on the rise.
Implications for Policy

• A bank run turned what could have been a relatively small housing correction into a major disaster.

• The problem was not so much in the commercial banking system.
  • Indeed, the commercial banks acted as ‘shock absorbers’ for the system.
  • ‘Too big to fail’ and ‘lax lending standards’ in banks not the first order of business.

• The problem was the shadow banking system.
  • It was vulnerable to runs because it had no protection from a central bank.
  • Must be careful to spot bank-like institutions and make sure they are not vulnerable to runs.
Banking Crisis, the ‘The Panic of 2007’ (Gorton)

• Example of a Bank:
  • bank takes a $1 deposit and promises to repay $1 in one period.
  • It lends the money to a firm, which promises to pay the $1 back in two periods (zero interest!)
  • *Maturity mismatch.*

• If depositors at *one* bank want money back....
  • Bank can *roll over* liabilities
  • Bank can sell assets to another bank.

• If depositors at *all* banks want money back...
  • Rollover crisis.
  • Banks must sell assets outside industry where assets are not well understood.
  • Must sell at a loss (*firesale*).
Rollover Crisis: Role of Housing Market

• What matters is the actual value of assets and their firesale value.

• If bank is solvent under (firesale value), then probability of run is zero.

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<td>Deposits: 100</td>
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<tr>
<td>Banker net worth 20 (5)</td>
<td>Banker net worth 10 (-5)</td>
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- **Rollover Crisis Hypothesis:**
  - pre-2005, no crisis possible,
  - post-2005 crisis possible.